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Thomas Power

Technological University Dublin, thomas.power@tudublin.ie

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Global Macroeconomic Trends

Thomas Power

*Lecturer Economics and Financial Management
College of Engineering and the Built Environment
Dublin Institute of Technology
thomas.power@dit.ie*

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Abstract: *The business of real estate is but a subset of the wider investment markets and macroeconomic trends will significantly shape the way real estate investment decisions are made. The McKinsey Institute is a global economic consultancy firm providing cutting-edge research on a wide range of macroeconomic and business trends. This article reviews macroeconomic trends that they believe will transform the global economy. McKinsey research show that “over two-thirds of organic growth of western companies can be attributed to being in the right markets and geographies” and “companies that ride the tide succeed and those that swim against it usually struggle” (Davis and Stephenson 2006). Identifying these trends will help organizations and corporations navigate their way to success.*

Over the next twenty years the share of the world GDP will shift dramatically. Currently, Western Europe accounts for 30% of world GDP and Asia (excluding Japan) accounts for 13%. Growth rates are expected to merge by 2025 while the US will still account for the largest share of world output. (Davis and Stephenson 2006).

In a survey of over 100 companies since 1980, McKinsey Global Institute estimate that global financial stock (equities, bonds and bank deposits) totals \$118 trillion and this could increase to \$200 trillion by 2010. However, 80% of this stock is generated in four areas: the U.S. the euro area, Japan and the UK while 37% of global financial stock is dominated by the US. (Farrell, Key A.M., Shavers 2005).

What does the growth in financial markets tell us about global wealth? Economists call the ratio of financial stock to GDP (or the underlying economy) ‘financial depth’. GDP reflects current prices or the value of world output as measured in today’s prices. The value of financial assets equals the present value of the cashflows that they generate in the

future. For Farrell et al., the present value of financial stock has grown to almost three times the value of GDP from an amount roughly equaling GDP in 1980 (Farrell, Marcheva, Shavers 2005). In terms of real estate investments, financial deepening is positive because it means more liquid markets for savings and investments. However, as the authors make clear, financial depth does not give us any indication of the strength of an economy or its wealth. The financial depth of the US for instance is twice that of Norway but the US and Norway have similar per capita GDP. Furthermore Japan has great financial depth but is riddled with non-performing bank loans and bad debts (Farrell et al 2005).

An interesting finding of McKinsey's research is that nearly 50% of the growth in global financial assets from 1993 to 2003 is funded by debt. It seems that Ireland is not the only country with very high levels of debt. Debt issues have increased in all global regions with corporate debt showing fastest growth. (MGI global financial stock database 2006). The McKinsey Global Institute, however, point out some interesting regional variations. For example, France, Japan and Italy have greater growth in government debt because of large government deficits whereas corporate debt is the salient feature of growth in UK debt. Interestingly, securitisation of assets has become an important source of debt particularly in the US and Germany. Farrell et al. estimate that 36% of the overall increase in debt securities in the US and Germany is due to the growth in the securitisation of assets. In contrast, 4% in the UK, less than 1% in France and less than 2% in Italy's growth in debt securities results from securitisation. McKinsey notes that the rest of the world is far behind the trend in the US indicating significant growth prospects in this market. For example mortgage backed securitisation accounts for 76% of overall asset securitisation in the US. (MHI global financial database).

The US will remain the biggest financial market while the euro area (because of greater integration) will increase its

share. Japan will become less significant in the global financial hub while China's importance will grow. The Chinese economy accelerated in the 1980's driven mainly by manufacturing and foreign direct investment. China sucked in 8.3% of the world's FDI of \$53 billion, more than any other country. (Farrell, Khanna, Sinha, Woetzel 2006). In contrast growth rates in India took off in the 1990's with little government assistance or foreign direct investment (Khanna 2006). However both countries face structural problems. China is riddled with bad bank loans while India has very poor infrastructure indicating that companies that rely on just-in-time inventories will be disadvantaged (Farrell 2006).

Significantly for real estate investment and despite the demonstrations against globalization, McKinsey research shows cross border financial activity is growing. Cross border capital flows have tripled since 1995. This includes bank lending across borders and foreign purchases of equity and debt (Farrell et al 2006).

The Pensions Time-Bomb:

The populations of developed economies are ageing. The pensions and health care crises that this will generate will mean unprecedented tax increases. The only way this can be averted is through new higher levels of public sector efficiency and productivity. If no action is taken to deal with this impending crisis the fall in global financial wealth will have devastating effects on global savings and investments (Farrell, Ghai and Shavers 2006).

As the median age of populations increase (and save less) and because younger populations are less frugal, global savings rates will tumble. In 20 years time world household financial wealth will be \$31 trillion less if action is not taken to deal with the pensions crisis. (Farrell et al 2006).

Will a fall in the savings ratios lead to an increase in interest rates? For Farrell et al this need not necessarily be the case.

They point out that some economists suggest that there will be less demand for mortgages, less government expenditure in infrastructure and less investment by business in capital equipment to keep pace with a fall in population. On the other hand, the authors suggest, a falling savings ratio could mean persistent budget deficits by governments. This will result in higher public sector demand for money on the money and capital markets and consequently higher interest rates. The effect will be 'crowding-out' (something the Irish economy was familiar with in the 1980s) of private sector investments.

What needs to be done? The authors of this report provide evidence that raising the retirement age, increasing the birth rate or easing restrictions on immigration will not be sufficient. Indeed more liberal immigration policies won't be effective because immigrants are a small fraction of the country's population. Thus allowing more immigrants would add a tiny fraction to a country's financial assets.

Similarly, according to McKinsey's research promoting population growth through child tax credits and generous maternity leave would have negligible effect by 2024 because households do not reach their prime years until middle age (30 to 50). In fact, they say, these policies "would make the situation worse by adding child dependency to a workforce already supporting a larger number of elderly" (Farrell et al).

Furthermore, the authors contend that concentrating on economic growth (and by extension higher incomes) won't solve the problem. The important relationship is between income and savings and, unfortunately, as income rises so does consumption. As an example, Farrell suggests that a 1% increase in average income growth, a massive increase, would reduce the financial gap in the United States by just 10%.

McKinsey's solution to the impending financial gap brought about by ageing populations is two fold. First of all

households and governments must increase their savings and secondly economies must boost the rate of return on assets. As an example the authors provide evidence that increasing the rate of return on the \$56 trillion savings in the US, UK, Germany, Japan and Italy would go a long way to sway the impending global financial gap. For example, if Germany were to increase its return on its financial assets to 0% from the historic average of minus 1.1% it would “completely eliminate its financial shortfall” (Farrell et al 2006). The researchers’ solution to improving rates of return is greater market efficiency and policies that promote competition, financial regulation, tax incentives for productive saving and investor education.

An interesting finding from the research is that in many countries today younger generations earn more and save less than their parents’ generation. The research suggests that if the younger generation in Japan, for instance, saved as much as their elders while continuing to earn high incomes, one-quarter of Japan’s wealth shortfall would be eliminated by 2024.

In addition, public sector saving, by controlling fiscal deficits, will be critical in averting the financial gap. This can be done more efficiently through gains in public sector productivity. However, improved productivity is not synonymous with layoffs and cutbacks (Dohrmann and Mendonca 2006). In fact layoffs can lead to poorer productivity and poorer services. Productivity can be achieved by improving the quality and quantity of output. One of the ten principles of economics is the key to wealth creation. In the public sector, for example, reducing crime and improving educational outcomes can lead to improved productivity. Reliable data on government productivity is not available in most countries but estimates in the US suggest that if the gap between US private and public sector productivity could be

halved, it would increase public sector productivity by 5R% to 15%.

Dohrmann and Mendonca, however, ask whether it is fair to compare private and public sector productivity. They note the contribution of economist Wiliam Beaumol who wrote that services might lag behind manufacturing because of the labour intensive nature of their work. As Dohrmann and Mendonca put it – “ it will always take the same amount of time for a teacher to read a story or for a nurse to administer a shot”. For Beaumol, since public sector provides services such as education, policing and health care there is little scope for productivity gains.

However analogies do exist between private and public sector productivity. For instance, Dohrmann and Mendonca cite the analogy between processing social welfare payments and the processing of insurance claims. In addition, they suggest that the management of real estate is much the same in the public sector as in the private sector. In these areas the private sector has found ways to boost their productivity and it seems plausible that the public sector can do the same. However, the McKinsey research is clear in that calls for public productivity should not be used as an excuse for “union bashing” – often the case with right-wing ideologues. It simply means that greater efficiency will mean more resources and money will be available to fund the impending pension and health care needs.

The biggest obstacle to improving productivity in the public sector is the lack of competition. The MGI, in research conducted ten years ago, found that private sector companies that had the lowest productivity were usually monopolies. Their conclusion is that without competition, managers will have little incentive to take on risk. This is concurrent with another of the ten principles in economics that people respond to incentives. For example,

governments can create competition by outsourcing back office services such as real estate management and procurement. Performance measurement management systems and benchmarking surveys make governments more accountable. Information programmes to citizens of the need for public sector transparency and accountability will force public sector productivity because it is citizens that will be saved from the financial time-bomb that they face.

So which is it to be? Higher taxes and lower quality of output to finance the financial gap or improved public sector productivity. To help answer this very important it is important to remember that it was the public sector that was responsible for some of the world's most amazing management feats from smallpox eradication, bullet trains and space flight.

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